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VIA UPS OVERNIGHT NO54 5365 43 5
Mr. David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
Building 85
Denver Federal Center
Denver, Colorado 80225

Re: Notice of Proposed Rulemaking

Dear Mr. Guzy:

Vastar Resources, Inc. ("Vastar") is one of the largest independent (non-integrated) oil and gas companies in the United States. Vastar is engaged in the exploration for and the development, production and marketing of natural gas and, to a lesser extent, crude oil in selected major producing basins in the United States.

Vastar appreciates this opportunity to comment on MMS's proposed amendments to modify the valuation procedures for both arm's-length and non-arm's-length crude oil transactions, establish a new MMS form for collecting value differential data, and amend the valuation procedure for the sale of Federal royalty oil. This proposal was published at 62 F.R. 3741, January 24, 1997 (Proposal).

Vastar is a member of several industry trade associations. In addition to these comments, Vastar wishes to state its support for comments submitted by the American Petroleum Institute ("API"), the Independent Petroleum Association of America ("IPAA"), and the Domestic Petroleum Council ("DPC"). Each of these groups has developed and discussed thoroughly several common issues. Vastar agrees with most of the statements and analysis contained in the trade association comments, and does not intend to restate them here. Rather, Vastar's comments will focus on those areas where Vastar has specific concerns or additional insights. Because Vastar has no oil production in California or Alaska, these comments will not address issues that are unique to those areas.

The agency's stated intent in proposing these amendments is to decrease reliance on oil posted prices and assign a value to crude oil that better reflects market value. Vastar supports changes that would simplify the royalty payment process and provide greater certainty in arriving at an accurate and timely value for production at the lease. Unfortunately, the Proposal fails to accomplish either of these goals, and Vastar feels compelled to voice its opposition. The proposed new Form MMS-4415 and the procedures for calculating values will create a large amount of additional work for the regulated community, but will not increase accuracy in calculating values at the lease or reduce the level of contention between the MMS and payors. Vastar also has serious concerns regarding MMS's treatment of statutes, lease terms, and contract law principles, bringing into question the legality and enforceability of some aspects of the Proposal.

Requested Comments

MMS specifically requested comments on the following matters:

1. *Use of interim rule.* Vastar is strongly opposed to MMS's consideration of an interim rule, with subsequent changes being made without opportunity for notice and comment. Rulemaking without notice and opportunity for comment is authorized only under narrow circumstances,[1] none of which exist here. MMS's justification for suggesting an interim rule is to further evaluate the methodology proposed, and to make a revision without a new rulemaking.

Changing royalty valuation methods results in huge costs both to the agency and to the regulated community. Accounting systems must be changed; personnel must be retrained, and different staffing levels may be needed; audit standards and procedures must be conformed. In addition, changes such as those contemplated in the Proposal affect the economic evaluation of exploration and development opportunities. The possibility of future changes to royalty valuation injects a risk that cannot be quantified into those calculations and discourages lessees from pursuing operations.

Because of the tremendous impact on the regulated community caused by changes in royalty valuation regulations, Vastar believes that it is imperative to fully evaluate methodologies ***prior*** to implementation, and to involve the regulated community through formal rulemaking procedures at any time that changes are to be made in those methods.

2. *Appropriate indices for Alaska and California.* As noted above, Vastar has no production in these states. Vastar would point out, however, that there are many regions within the United States which, for all practical purposes, are just as remote from Cushing, Oklahoma as California and Alaska.

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1 Title 5 U.S.C.A. §553(b)(3) provides in pertinent part as follows:

> Except when notice or hearing is required by statute, this subsection does not apply--
> (A) to interpretive rules, general statements of policy, or rules of agency organization, procedure, or practice; or
> (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

3. *Use of market indicators (indices) to determine royalty value under proposed §206.105(c)(2).* This issue will be discussed in greater detail below.

4. *Use of NYMEX as the index value, and possible alternatives.* This issue will be discussed in greater detail below.

5. *Selection of the proper prompt month.* As a general proposition, Vastar believes that in order for any valuation system to reflect the actual value of the oil, production should be valued i) based on the time of production, ii) using contemporaneous sales, iii) which involve physical barrels. This issue will be discussed in greater detail below.

6. *Publications that should be used in applying rules in the Proposal.* This issue will be discussed in greater detail below.

7. *Alternative valuation techniques based on local market indicators.* In general terms, Vastar would recommend a benchmarking system that reflects the market for physical barrels. This issue will be discussed in greater detail below.

8. *Suggestions on ways to value Federal oil production based on market indicators in the vicinity of the lease, with the following in mind:*

   a) *The methods should not rely on posted prices unless they account for the difference between postings and market value.*

   b) *The methods must account for value differences related to quality and location.*

   c) *The methods must be widely applicable and flexible enough to apply nationwide.*

   d) *Most importantly, the methods must reflect the general concepts of fair market value—the agreed-upon cash price between willing and knowledgeable buyers and sellers if neither were under undue pressure.*

Vastar will address this issue in greater detail below. However, it is important to emphasize from the outset that posted prices should not necessarily be rejected, and it is very likely that any system that can be applied nationwide will, by definition, fail to account properly for market conditions at the lease itself. This failure permeates the entire Proposal. None of the leases issued by the Federal government to date require ***or permit*** the parties to use oil values that are based solely on prices received by other parties for other oil of differing qualities at locations hundreds of miles away from the lease. However, adoption of the Proposal would do just that. In addition, the Proposal would impose enormous burdens on the lessee beyond the scope of the lease agreement. These burdens include the assumption by the lessee of all credit risk, performance risk, pipeline risk, and inventory risk. These risks represent a very real and substantial part of the value that would be prescribed under the Proposal's index pricing mechanisms. The Federal government, as the lessor, has the right to fair market value at the lease, not a futures commodity value at a commodity trading center.

9. *Deletion of §206.102(h) ("Notwithstanding any other provision of this section, under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances determined*

interest owner (Seller) in an offshore lease (Lease A) sells its share of production to the operator (Buyer), and the point of sale is at the inlet flange of facilities on a lease (Lease B) several blocks away, which is also operated by Buyer. Assume further that the production will be hauled to Lease B through a pipeline owned and operated by the lessees (Haulers) of Lease B, including Buyer. The oil sales contract will be between the Seller and the Buyer, while the hauling agreement will be between the Seller and the Haulers. If the MMS reviews these agreements and asserts that low rates in the hauling agreement constitute additional consideration for the oil, then Seller could be forced to pay royalties based on index prices as a floor, and perhaps more should the MMS so decree. This might be imposed on Seller even if the actual costs of hauling the oil were fully deductible.

The unreasonable, one-sidedness of the agency's approach becomes apparent when the ordinary risks of oil marketing are considered. If the hauling rates are low, then the MMS, with full benefit of hindsight, will require the Seller to use a high index price and deduct a low hauling cost to arrive at a royalty value in excess of the proceeds that the Seller could receive. On the other hand, if the hauling rates are high and the index prices are low, then the MMS, again with the benefit of hindsight, can demand payment of royalties on the price under the sales agreement, and disallow all or a portion of the hauling charge as "unreasonable." Unfortunately for the lessee, it has none of the benefits of hindsight. It must arrange for delivery and sale of oil with all of the risk and uncertainty of future price volatility. In this example, there was no demonstration that the lessee acted improperly or in bad faith. He had simply entered into more than one contract, and the MMS had chosen to claim that part of the hauling agreement constituted consideration for the oil.

The second limitation on use of gross proceeds discussed by the MMS arises from the agency's determination (based again on hindsight evaluation) that gross proceeds don't reflect the reasonable value of production because of misconduct ***by the contracting parties*** or breach by the lessee. Vastar does not suggest that a lessee's misconduct should go unnoticed. However, if gross proceeds are reduced by misconduct of the other party to a contract, then the lessee has been harmed in the same fashion as the lessor. It is patently unfair to place the lessee in the position of guaranteeing the good conduct of a third party. Existing rules clearly require that the lessee must be an active participant in the alleged misconduct before the MMS can disregard gross proceeds received under the contract. If adopted, the proposed rules must be modified to make the Proposal conform to the current standard.

The Proposal would also prohibit the use of gross proceeds under arm's-length contracts if the lessee or any affiliate purchased ***any*** crude oil in the US within two years prior to the production month.[10] This prohibition also applies to lessees who enter into crude oil exchange agreements. MMS's stated rationale is as follows:

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10 Id.

Nevertheless, the Proposal prohibits use of admittedly "true arm's-length sales" "because of concerns that multiple dealings between the same participants, while apparently at arm's length, may be suspect concerning the contractual price terms."[7]

MMS's fears are misplaced, the producers' use of contracts in this manner is already precluded, and MMS has an enforcement mechanism already in place to address the concern raised. The fears are misplaced because lessees have a vested interest in obtaining the highest value possible for production, and because, as the MMS acknowledged in 1988, "[I]ndustry can identify its own arm's-length contracts . . . and it is in [industry's] best interests not to classify non-arm's-length contracts as arm's-length because of the threat of both high interest costs and possible penalties."[8] These factors have been effective incentives for the regulated community, and there has been no demonstration that industry has abused this system.

Producers' use of contracts in "multiple dealings" or in exchanges with other parties in a manner that intentionally and artificially drives down the price of oil is already precluded. Agreements to fix price are illegal. Producers have a natural aversion to criminal penalties. In addition, an arm's-length contract, under both existing rules and the Proposal, requires a contract or agreement between persons with opposing economic interests regarding that contract. If those opposing interests are removed, then the contract is no longer arm's-length and another measure must be used to establish gross proceeds. Consistent with the considerations that the MMS itself noted as referenced above, industry has sought to conduct business in its best interests under this standard.

Even if there were a basis for MMS's fears and industry were involved in artificial price manipulation, the MMS already has enforcement mechanisms in place that address the concern that it raised. The MMS has extensive audit powers. Lessees face stiff penalties for various breaches of the lease agreement, which can jeopardize leases, restrict operations, or even include perjury in some instances. Criminal violations can be referred to the Department of Justice.

MMS indicates that gross proceeds under arm's-length contracts may still be used. However, the limitations imposed by the agency on the regulated community's use of gross proceeds renders this option meaningless. First, MMS states that it may require valuation equal to ***the greater of*** index pricing or the total consideration received if the oil sales contract doesn't reflect all actual consideration received.[9] It appears that in order to invoke this position, MMS could simply claim that some consideration, no matter how small, may have arisen from a document other than the "sales contract." For example, assume that a non-operating working

7 62 FR at 3743.

8 53 F.R. 1184, under Acceptance of gross proceeds as the value for royalty purpose.

9 62 FR at 3743.

believes that the Proposal extends far beyond the terms of the lease agreement, the regulations, or applicable statutes. This issue will be discussed in greater detail below.

14. On RIK, MMS requests comments from interested parties as to whether this proposed method of valuation would meet the fair market value definition of the Outer Continental Shelf (OCS) Lands Act. Vastar believes that delivery of royalty in kind, in and of itself, meets the definition of fair market value for all purposes. Any proposal that requires a lessee to deliver a full share of production ***and*** act as an insurer to guarantee a minimum value to be received by the lessor exceeds MMS's authority under the lease agreement and applicable statutes and regulations.

General Comments

Vastar would offer the following additional comments regarding the Proposal:

- *Change in the definition of arm's-length contracts*

The MMS is proposing a significant, substantive modification to the existing definition of arm's-length contracts. First, the "market place" requirement has been removed. It was initially included "in support of the concept that arm's-length contract must be between nonaffiliated persons."[4] Vastar believes that other express language of the definition already addresses this issue, and removal of the "market place" requirement should have no impact on this result. However, Vastar would emphasize that removal of the requirement should not be construed as a rejection of the validity of prices arrived at in the market place. A lessee must dispose of physical production in the market places to which it has access, and the value of oil for royalty purposes must ultimately be tied to the values in those market places.

In addition, the Proposal states, "MMS may require the lessee to certify ***the percentage of*** ownership ***or*** control."[5] The italicized language is new. "Control" is defined as a function of ownership. Inserting the word "or" creates a new and separate certification, but the nature of this certification is unclear. The word "or" should be removed.

- *Broad rejection of values contained in arm's-length contracts.*

MMS acknowledges in the Proposal that ". . . MMS expects that a relatively small volume of Federal oil production would be valued using the arm's-length gross proceeds method. In fact, MMS considered requiring all production to be valued as if not sold at arm's length."[6] In the next sentence, however, the MMS expressly acknowledges that there are "true arm's-length sales" which justify use of the gross proceeds provision, and implicitly acknowledges that these "true arm's-length sales" are not limited to independent producers or to producers with no reciprocal purchases or trades.

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4 Id., under Section by Section Analysis and Response to Comments, Section 206.101.

5 62 FR at 3751, emphasis added.

6 62 FR at 3744.

applicable law makes a lessee's practices in *receiving* oil relevant to the value received for the *sale* of production.

Second, the form has very little practical utility. Due to the time lag between collecting the information and publishing the calculated differentials, it is very likely that the published differentials will not match the actual costs borne by the lessee, and often will bear little resemblance. Due to seasonal changes and unpredictable fluctuations in costs incurred by the lessee to move and handle oil, the annual calculation of differentials based on prior-year data has no practical utility.

Third, MMS's estimate of the burden on the regulated community is unreasonably low. Given the large volumes of oil involved and the volatility of the crude oil market, the task of incorporating each trade into the proposed MMS-4415 would be extremely daunting. In addition, the form not only requests information regarding oil sold, but also oil *received*. In calculating the amount of time required to complete a form, the MMS appears to have considered only the time necessary to report oil *sold*. At a minimum, MMS's estimated burden on lessees should be doubled to account for the "other half" of the form.

Fourth, the proposed form would not enhance the quality, utility, or clarity of the information to be collected. Volumes, prices, and adjustments are already being reported. This form will not improve the accuracy of this information, nor will the format improve the utility of the information. Instead, it simply requires both the regulators and the regulated community to utilize the same information over again. MMS should not confuse additional utilization with additional utility. They are not equivalent. The form will do nothing to clarify the information collected. On the contrary, information on the proposed form will be more general in nature and cannot be related to specific production sold from a specific lease.

Finally, the proposed form increases information collection burdens on royalty payors. All production must still be reported monthly; all sales must still be reported monthly; all adjustments must still be taken monthly; all statements, records, and payments remain subject to review and audit by the agency. If the processes contemplated in the new form are implemented, burdens on royalty payors will *increase* to handle this *additional* report, and will increase even more to add oil *received*, even though it was not *produced* by the lessee.

In sum, the proposed form should be flatly rejected under the applicable standards in the Paperwork Reduction Act of 1995. Vastar has been advised that the OMB has already refused to approve the form under those standards. Because the defects inherent in the form are so substantial, Vastar does not believe that any revision of proposed MMS-4415 could cure its problems.

13. On RIK, MMS requests comments from crude oil producers and small refiners as to the impacts of the proposal on them. In general, Vastar supports royalty-in-kind programs, in that it ensures that both the lessor and lessee receive the intended benefits of the mineral estate. However, to the extent that a lessee might be required to deliver a full royalty share of production in kind *and* act as an insurer to guarantee a minimum value to be received by the lessor, Vastar *pursuant to this subpart.").* The agency's proposal to delete this provision appears indicative of its intent to value production on a basis other than gross proceeds. Indeed, the Proposal acknowledges the agency's expectation that only "a relatively small volume of Federal oil production would be valued using the arm's-length gross proceeds method."[2]

The gross proceeds method of valuation has been in place since its promulgation in 1988. In issuing the final rule, the MMS stated, "MMS maintains that gross proceeds to which a lessee is legally entitled under arm's-length contracts are determined by market forces ***and thus represent the best measure of market value.***"[3] Although MMS has not identified any change in the market place that would diminish the validity of its own statement, the Proposal appears to flatly reject gross proceeds as an appropriate measure to establish value for royalty purposes. To the extent that deletion of §206.102(h) demonstrates a rejection of market transactions at the lease as the best indicator of market value, Vastar believes that it constitutes an arbitrary change in philosophy by the agency and Vastar strongly disagrees with this philosophical shift.

10. Alternative methods for adjusting index values. At this point, Vastar would simply emphasize that the existing benchmark system and other mechanisms already being used by the regulated community do a far better job of reflecting market value of physical production. This issue will be discussed in greater detail below.

11. Initial list of market centers and market centers and aggregation points, including suggested additions, deletions, and other modifications. MMS's initial list is woefully inadequate. The differences between the locations from which oil is produced, the geographic considerations that exist, the transportation options available, the values resulting from aggregation and blending, and the market conditions at each lease would require a much larger list.

12. Form MMS–4415 (See Appendix A), including:

- *a) Its layout and information requested,*
- *b) Frequency and timing of submittal, frequency and timing of MMS's calculations and publication of differentials, and*
- *c) All other relevant comments.*

This issue has been considered and discussed in greater detail by others. Vastar wishes to emphasize its support for those commentors who have demonstrated that time and costs associated with the proposed form will be far higher than estimated by the MMS.

Vastar believes that the agency has dramatically understated both the time and cost involved in using the form. This form and its stated purpose are fatally flawed. First, the information requested goes far beyond anything that the agency needs in order to verify the accuracy of royalty payments. The Federal government has contracted for payment of royalties for actual production from the leased property. Nothing in the lease agreement or in any

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[2] 62 F.R. at 3744.

[3] 53 F.R. 1184, under Acceptance of gross proceeds as the value for royalty purpose.

MMS is proposing this limitation because of concerns that multiple dealings between the same participants, while apparently at arm's-length, may be suspect concerning the contractual price terms. Just as with exchange agreements (discussed later), a producer may have less incentive to capture full market value in its sales contracts if it knows it will have reciprocal dealings where it may be able to buy oil at less than market value.[11]

This rationale is defective, both in legal analysis and in fact. Under present rules, the lessee already has the burden to demonstrate that a contract is arm's-length.[12] To satisfy this burden, the lessee must show that parties to the agreement have opposing economic interests regarding that contract.[13] Under the facts described by the MMS, a lessee would be required to demonstrate that the buyer and seller under the contract have opposing interests regarding that contract. If the lessee fails to satisfy its burden, then the contract is not "arm's-length" by definition. Legally, there are no "arm's-length contracts" in which the seller lacks incentive to obtain the highest price.

The MMS is mistaken in its factual approach as well. Vastar is an independent (non-integrated) oil and gas company. It has no refining capacity. Vastar has one shareholder that owns approximately 82% of its outstanding, voting shares, which would constitute an "affiliate" for purposes of the royalty valuation regulations. The other 18% is held by numerous other parties, none of whom own 10%. Vastar's affiliate owns refining operations principally on the West Coast. Vastar does not deliver its production for refining by this affiliate at any price. In fact, Vastar's production and its affiliate's refining operations are cut off from each other by the same geographic separation which caused the MMS to propose a different valuation mechanism for production from California and Alaska. Vastar sells production from its leases and the affiliate purchases crude oil for its refineries independently. When marketing its crude, Vastar may enter into an exchange, buy/sell, or swap transaction with its affiliate or one of the affiliates divisions, but only with the opposing economic interests in effect. Oil purchases by Vastar's affiliate under these circumstances should not preclude Vastar, or other lessees who are similarly situated, from utilizing gross proceeds to establish the value of oil.

Vastar does not (and is unable to) track relative volumes, qualities, locations, and other factors relating to its purchases and sales of oil *vis a vis* other parties on a nation-wide basis, and is unaware of any other lessees who might be engaged in such conduct. It seems ludicrous for MMS to suggest that industry has a system so sophisticated that it can account for all of these factors in a manner that will arrive at a "relative parity" which adequately protects every lessee from being short-changed. Vastar questions the legal implications of such a system. The simple fact is that the only way for a lessee to ensure that it receives full value for the production from its

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[11] Id.

[12] 30 CFR §206.102(b)(1)(i).

[13] 30 CFR §201.101, definition of *Arm's-length contract*.

lease is to contract for the full value of that production when it is sold. A system to establish "relative parity" with another lessee (much less the entire domestic petroleum industry) through reciprocal dispositions of oil production at understated prices is a practical impossibility. Making this type of a system work for oil sales and purchases which occur as much as two years apart is unthinkable.

MMS requested input regarding an alternative proposal whereby a lessee would be prohibited from using gross proceeds only if the lessee purchased oil from the same person (or its affiliates) to whom the lessee sells oil within the prior two years. Vastar does not view this as being substantially different than the arrangement contained in the body of the Proposal. The problems of maintaining "relative parity" remain. In addition, under the proposed alternative, it appears that a lessee's use of gross proceeds would still be precluded in the event that reciprocal sales took place between two parties. It would be pointless for a lessee to differentiate between sources of oil received if the consequence of receiving oil is the same regardless of the source.

The Proposal would also prohibit a lessee from using gross proceeds if oil production is *subject* to a "call." The Proposal makes no distinction between the pricing provisions of the call (e.g., postings, market index based, or matching), but appears to assume that all calls, even when not exercised, deprive the seller of market value. Vastar does not agree with this assumption.

Crude oil calls were originally created by companies that wanted to ensure that they would have access to a reliable supply of oil for other purposes, such as refining. The price to be paid for the oil under the call was generally the posted price--which is the same price that a refiner would be willing to pay any other producer in the same field for similar quality production under prescribed conditions. This continues to be the case in many fields. In many current agreements, call language is often index based. Other calls are "competitive" or "matching" calls, which means that the party holding the call right has the right to match third party offers to purchase the production. In each of these arrangements, the call price is related to markets available at the lease.

For a variety of reasons, the holder of the call right may elect not to exercise it. In such an event, the party subject to the call right is free to sell the production to any party it chooses, and at any price that the market will bear. The call has become irrelevant to the disposition of the oil at the time it is produced. Unless the actual purchaser of the production is affiliated with the producer, there is no reason to exclude these oil sales from being based on gross proceeds under arm's-length contracts.

An arm's-length contract for sale of oil at the lease constitutes the best measure to establish actual value for oil production in 1997, just as it was in 1988. This is the value on which the Federal government is entitled to its payment of royalties. To the extent that an alternative valuation mechanism is adopted, it must be designed to reflect this value.

- ***<u>MMS's approach to indices, prompt month, and adjustment mechanisms fails to account properly for actual value of production, and improperly increases both the burdens imposed on lessees as well as the share of proceeds allocated to the Federal government.</u>***

In 1988, the MMS recognized that value must be established at the lease using arm's-length contracts. If value could not be established in that manner, then alternative valuation methods may be used. Each alternative method seeks to provide the next closest means for establishing value at the lease.

The Proposal starts from the opposite end of the crude oil market--the point of sale as a paper commodity. This is the farthest possible point from the lease, and is consequently the least likely point to provide a measure that actually reflects value at the lease. The time period used for establishing the sale price is not the same as the time with the production is being sold, removing value yet another step away from the value of real barrels. Adjustments are provided in the Proposal in an attempt to arrive at a value at the lease. However, as is amply demonstrated in numerous comments submitted by trade associations, the adjustments proposed by the MMS are wholly inadequate. The lessee is compelled to value production on the basis of a commodity sale at a point far beyond the lessee's control, and the resulting value includes upgrades provided by the NYMEX trading mechanism that cannot be captured at the lease where the production must be valued.

Vastar supports any proposal that simplifies the royalty payment process and reduces the level of uncertainty in royalty valuation, provided that the value is timely and accurate. Vastar also believes that index pricing mechanisms can lend themselves to simplification. However, Vastar cannot and will not support a proposal such as this one. First, the process is not simplified. Rather, all of the old administrative burdens will remain in place, additional reporting must be done, and new "prompt month" periods must be tracked in order to establish values. To Vastar's knowledge, the prompt month periods described in the Proposal are not presently tracked by any producer or by the MMS for royalty valuation purposes. Both the agency and the regulated community will be forced to revise their accounting systems and add another layer of pricing schedules. Second, the level of uncertainty is not reduced. Oil valuation will be made on the basis of hedging transactions which are by their very nature *un*certain. Third, the value is unlikely to be accurate. The valuation mechanism in the Proposal has some inherent flaws. The time period used for establishing the sale price (NYMEX) is not the same as the time period used for establishing the Cushing/Market Center Location Differential (Platt's). This mechanical flaw, in conjunction with the future pricing mechanisms (NYMEX and Platt's) being used in the Proposal, create a prompt month index price that may not be physically achievable by producers. Under the Proposal, however, no oil will ever be valued at the lease. To aggravate this situation, some adjustments under the Proposal will be based on information that is more than 12 months out of date. This creates a burden not only for the producer's administrative functions, but also for the cash flow planning for the corporation.

The Proposal would implement a system of calculating royalties in a manner that will generate arbitrary values that cannot be obtained at the lease. A different approach must be used.

• ***The Proposal fails to provide appropriate allowances for sales at the lease.***

A prominent omission in the Proposal is the lack of any adjustment for costs incurred between the wellhead and the first aggregation point in the event that sales take place at the wellhead. If oil is sold at an aggregation point, the Proposal provides an adjustment to the NYMEX prompt month average for certain actual costs between the wellhead and the aggregation point. When production is sold at the wellhead, the same costs are incurred, but will often be reflected as a reduction in the price received for the oil. However, nothing in the Proposal would permit a lessee to adjust the NYMEX price for this value.

• ***Mechanisms already exist, and other alternatives should be considered, which can establish an accurate value of production for royalty purposes, including postings, other local market value indicators, and royalty in kind programs.***

These problems do not necessarily render index pricing invalid. The recent similarities of upward and downward price movement between NYMEX futures values and spot prices (after a delay in time and reduction in price) should not be completely disregarded. Available data demonstrate that there is a relationship between the two. Unfortunately, the MMS appears to have jumped from this similarity of price movement to a conclusion that NYMEX futures actually ***drive*** the value of oil. Vastar disagrees. NYMEX has, and always will, represent the value that commodity traders ***hope*** to receive (or beat) in the future. These hopes are based upon predictions of future prices and conditions that may or may not prove to be accurate. If the predictions are not accurate, then prices may be substantially different from the NYMEX futures values. Commodity traders are able to hedge against these events through paper trades. Unfortunately, the lessee must produce physical barrels, sell those physical barrels, and do so based on the conditions that actually exist at the lease when the sale is made. The NYMEX values are based on predictions for barrels that are sold in Cushing, Oklahoma, a market to which the lessee may have no access. In many instances, Cushing is nothing more than a remote market where no physical barrels from the lease can be sold.

To reduce the problems with the NYMEX pricing mechanism, other indices must be considered. In the Proposal, MMS already recognizes other publications for purposes of various adjustments to the NYMEX price. Many of these other publications, such as Platt's Oilgram, identify prices in more localities. These indices start from a point closer to the wellhead, which makes them more attractive as indicators of value at the lease. Vastar does not suggest that any value based upon Platt's would automatically be acceptable. However, a legitimate, local index for crude oil that creates a presumptive value for production could be helpful. In the event that a lessee chooses use a different price, it should be prepared to justify the different price. In the event that the MMS seeks a different value for royalty valuation purposes, the MMS should bear the burden to demonstrate that the index is invalid and should be entitled to enforce a different value on a prospective basis only. Either party's demonstration of a different value should be based on the same benchmark system that is currently in place. Using an index in this manner provides certainty for both the lessor and the lessee, and ties any departure from the index to actual prices obtainable in the field under arm'-length contracts.

Another alternative would be to base royalty on values that the MMS is able to realize from the sale of oil in kind. Delivery should occur on or immediately adjacent to the lease. Delivery of the royalty share in kind would constitute full and final payment of royalty on the applicable production as provided in the lease. Royalty payments for other production would be based on the net proceeds that the MMS is able to obtain for oil under terms that are also available to lessees. This is the level of consideration contemplated by the parties under the terms of Federal oil and gas leases, which the Federal government drafts and issues for its own benefit. If a different consideration were contemplated by the lease, then it would not provide that deliveries of royalty in kind would be made on or immediately adjacent to the lease.

Thank you for providing this opportunity to comment on MMS's proposal. Improvements could be made to the current system of royalty valuation and payment. However, Vastar does not believe that the Proposal would achieve any of the needed improvements, and more likely would aggravate existing problems.

Very truly yours,

Clay Bretches for Karl Kurz 5/28/97

Karl F. Kurz
Manager
Crude Oil and Liquids Marketing

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